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PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

**Telecommunications Division
Carrier Branch**

**RESOLUTION T-16855
August 19, 2004**

R E S O L U T I O N

Resolution T-16855. Verizon California Inc. (U-1002-C). Request for authority to revise Tariff Schedule Cal. P.U.C. No. D&R, Rule No. 2, Application For Service, Income Tax Component of Contribution (ITC) and Advances Provision to reflect a rate change from 31.9% to 18.0% as the result of the Jobs and Growth Tax Relief Reconciliation Act of 2003.

By Advice Letter No. 10584, filed on August 12, 2003.

Summary

This resolution directs Verizon to file an application to request clarification of Finding of Fact (FOF) 3 in D.96-10-037, and FOF 15 in D.02-10-040 as to whether developers making contributions in aid of construction (CIAC)¹ are entitled to refunds of over-collected federal taxes they paid to telecommunications utilities calculated pursuant to “Method 5” for the period from September 12, 2001 to September 11, 2003.

Background

A. Federal tax law regarding CIAC

In 1986, President Reagan signed into law the Tax Reform Act of 1986 that made CIAC taxable under the Internal Revenue Code. Under the Tax Reform Act, utilities must recognize CIAC as income. Prior to 1987, contributions were not taxed. In D.87-09-026, the Commission placed the burden of the tax – called the Income Tax Component of Contribution (ITCC) -- on the contributor, based on the premise that the person or

¹Contribution-In-Aid-of-Construction (CIAC) means any amount of money or other property contributed to a “regulated public utility” to provide services for the expansion or improvement of the utility’s facilities.

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entity that causes the tax pays the tax. The Commission determined that the utility should pass along the tax generated by that income to the contributor as a fee, calculated with a Net-Present-Value² method, using depreciation, federal and state rates, as well as a rate of return.

There are five alternative rate making methods in D.87-09-026 to address the federal taxability of CIAC. The two methods at issue here are Methods 2 and 5:

1. Method 2: CIAC from developers is grossed up for income tax. That is, the developer pays the utility the CIAC amount plus the ITCC owed on that CIAC amount. Benefits of future tax depreciation are passed through to general customers.
2. Method 5: CIAC from developers is grossed up for the net present value of the revenue requirement for rate base treatment of the ITCC. That is, the developer pays the utility the CIAC amount plus the present value of the utility's future tax liability on that CIAC amount. Because the developer's tax payment doesn't completely pay the ITCC, the utility pays the difference, ratebases the tax, and recovers the difference over time in rate of return.

The Job Creation and Work Assistance Act of 2002 (2002 Act) was signed by President Bush on March 9, 2002. Effective for property acquired after September 11, 2001 until May 5, 2003, the 2002 Act allowed a bonus depreciation of 30% in the first year. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (2003 Act), effective for property acquired after May 5, 2003 and before January 1, 2005, increased the bonus depreciation to 50% in the first year. Both the 2002 Act and 2003 Act provided that it would not be practical for utilities to specially identify and refund gross-up fees to each individual customer on a retroactive basis.

B. The SBC Advice Letter regarding CIAC/ITCC

On August 1, 2003, SBC California (SBC) filed Advice Letter (AL) 24059 to request authority to revise the ITCC rate from 33.0% to 21.0% pursuant to the 2003 Act, which reduced the ITCC tax rate. The rate decrease is effective through December 31, 2004. The reduced rate of 21.0% will return to 33.0% on January 1, 2005.

The California Building Industry Association (CBIA) protested the effective date of September 10, 2003 requested by SBC. CBIA raised the issue that according to the 2002/2003 Acts, the effective dates should be on September 11, 2001 and May 5, 2003,

² Present-Value theory assumes that a dollar today is worth more than a dollar tomorrow. Net-Present-Value is the Present-Value minus the initial investment.

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respectively, to reflect enactment of the two pieces of legislation that reduced the utility's income tax liability.

SBC uses Method 5 for computing the CIAC tax and contends retroactive application of the rate reduction would be an administrative burden. The administrative burden would include research on thousands of past transactions, determination if refunds have already been granted due to project activity, and location of business entities that may no longer exist after project completion. Therefore, SBC and CBIA agreed that SBC would change the ITCC factor to 21.0% at a later date than on the statutory date(s) on which the tax reduction benefits of the 2002 and 2003 Acts themselves terminate (May 5, 2003 and December 31, 2004, respectively).

Because of this settlement between SBC and CBIA, SBC filed AL 24253 on October 1, 2003, to request authority to effectuate SBC's and CBIA's agreement by extending the reduced ITCC rate of 21.0% for an additional thirteen (13) month period beyond the 2003 Act's sunset date of December 31, 2004 (to January 31, 2006). Telecommunications Division (TD) approved AL 24253, and CBIA subsequently withdrew its protest.

C. The Verizon Advice Letter regarding CIAC/ITCC

On August 12, 2003, Verizon filed AL 10584, to request a tariff revision that would lower its ITCC associated with CIAC from 31.9% to 18.0% due to the 2003 Act. The reduced rate of 18.0% is temporary and will end on December 31, 2004. On January 1, 2005, the rate will return to 31.9%.

TD approved Verizon's request for a tariff revision and allowed Verizon's AL 10584 to go into effect on September 12, 2003 as requested by Verizon. However, TD noted that two sets of federal tax law changes applicable to the ITCC went into effect on September 11, 2001 and May 5, 2003. Verizon failed to reduce the ITCC rate from 31.9% to 22.5% for the first federal tax law change. TD reserved the right to examine the issue of whether Verizon should have reduced its ITCC effective on September 11, 2001 and/or May 5, 2003, rather than only on Verizon's requested effective date of September 12, 2003.

Notice

Verizon states that copies of the Advice Letter had been mailed to adjacent utilities and/or other utilities. Notice of AL 10584 was published in the Commission Daily Calendar of August 15, 2003.

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Protests

CBIA protested the effective date of September 12, 2003, requested by Verizon in AL 10584. CBIA submits that the effective date(s) should be retroactive: (a) to September 11, 2001 to reflect enactment of legislation that first reduced the level of utility tax exposure for contributed property, i.e. the 2002 Act; and (b) to May 5, 2003, or the beginning of any tax year ending after May 5, 2003, to reflect enactment of the 2003 Act which further reduced utility income tax liability associated with contributed assets.

CBIA cites Conclusion of Law (COL) 12 in Decision (D.) 87-09-026 as the basis for claiming that retroactive applicability is required.

Conclusion of Law (COL) 12 in D.87-09-026 reads:

If a utility is not in a taxable position in the year that it receives a contribution or refundable advance, there is no tax liability. The tax gross-up received from the contributor under Method 2 or Method 5 should then be refunded to the contributor. If a utility collects a gross-up calculated using an incremental tax rate that is more than its incremental rate, as determined on a ratemaking basis, the difference between what was and what should have been collected should be refunded to the contributor.

On September 5, 2003, Verizon responded to CBIA's protest of CBIA to its AL 10584. Verizon argues that because it calculates CIAC using Method 5, it is not subject to any claims for refund. Verizon alleges D.96-10-037 rescinded COL 12 in D.87-09-026 and replaced it with new language that limits its applicability to those utilities, which use Method 2 for computing ITCC (i.e. only small water and telephone companies). The revised COL 12 as set forth in Finding of Fact (FOF) 3 in D.96-10-037 reads:

For utilities which elect Method 2, if the utility collects a gross-up using an incremental tax rate that is more than its incremental tax rate as determined on a taxable year basis without consideration of a tax credit or tax loss carry forwards, the difference between what was and what should have been collected should be refunded to the contributor.

Verizon also cited FOF 15 in D.02-10-040, which states that "utilities using Method 5 are not subject to any claims for refund of CIAC gross-up amounts."

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Discussion

TD has reviewed Verizon's AL 10584, the protest of CBIA, and Verizon's response to the protest of CBIA.

D.87-09-026 lays the tax cost of CIAC projects on the entity (i.e. the developer) causing the taxable event, thus preventing ratepayers from subsidizing developers. As set forth above, two sets of federal tax law changes applicable to ITCC went into effect over the past several years, one on September 11, 2001 and the other on May 5, 2003. It is TD's belief that the effective date(s) of the tax factor applicability should be based on the federal tax code and the specific dates when the utilities began to realize the benefits of reduced tax liabilities and expenses. Utilities should have the tax factors effective with the effective date of each tax law change.

TD believes that Verizon should have filed an advice letter to revise its ITCC rate each time the federal tax law changed it. TD believes that Verizon's delays in amending its tariffs to reflect the change in tax rates are unreasonable.

With regard to the issue of whether developers are entitled to refunds of over-paid ITCC amounts from utilities using ITCC calculation Method 5, TD believes the existing Commission decisions are unclear. COL 12 in D.87-09-026 required both Method 2 and Method 5 utilities to refund over-collected ITCC amounts to contributors. D.96-10-037 rescinded COL 12, adopted a new COL 12 that only discusses Method 2 utilities, and failed to clearly address the status of refunds by Method 5 utilities. FOF 15 in D.02-10-040, which relies on D.96-10-037, is unclear for the same reason.

In summary, TD believes that: (a) FOF 3 in D.96-10-037 is unclear, because it does not indicate whether or not utilities using Method 5 for computing ITCC are subject to contributor claims for refund of ITCC overpayments, (b) FOF 15 in D.02-10-040 is also unclear for the same reason, and (c) Verizon's claim that utilities using Method 5 for computing the tax are not subject to any claims for refund is questionable, because Verizon relies on unclear language contained in the above two FOFs to support its belief.

Comments

The draft resolution of the TD in this matter was mailed to parties in accordance with PU Code 311 (g)(1).

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On July 28, 2004, Goodin, MacBride, Squeri, Ritchie & Day, LLP, filed comments on behalf of California Building Industry Association (CBIA). Goodin, MacBride, Squeri, Ritchie & Day, LLP point out that:

- 1) It is not necessary to require Verizon to file an application to clarify what is an inadvertent mistake in D.96-10-037, as perpetuated in D. 02-10-040.
- 2) The draft resolution should be modified to eliminate the requirement for Verizon to file an application and to order Verizon to immediately refund improperly collected ITCC charges for the period from September 12, 2001 to September 11, 2003.

Goodin, MacBride, Squeri, Ritchie & Day, LLP indicate that there is no policy or equity reason that would support a determination by the Commission to exempt Method 5 utilities from refund liability for excessive recovery of ITCC. There is no legal reason to interpret D.96-10-037 or D.02-10-040 as standing for such an unfair and unjust proposition.

With regard to ordering Verizon to immediately refund improperly collected ITCC charges, Goodin, MacBride, Squeri, Ritchie & Day, LLP argues that Method 5 utilities are required by Commission decision to maintain the principle of “revenue neutrality” in assessing and collecting ITCC from developers. They claim that Verizon violated the mandated revenue neutrality principle by profiting from the tax consequences of CIAC changes and that Verizon should be required to refund to developers the improperly collected ITCC charges.

On July 29, 2004, Verizon filed comments and noted that:

- 1) D.96-10-037 is not unclear as to the status of refunds.
- 2) The draft resolution requirement that only Verizon refund amounts to developers would be discriminatory.

Verizon indicates that COL 12 in D.87-09-026 was originally adopted for those small utilities, who were not always in a taxable position. Large utilities were prohibited from using Method 2, which took into account potential refunds. Verizon claims that original COL 12 was incorrectly including Method 5 utilities. D.96-10-037 rescinded COL 12 in D.87-09-026 and adopted a revised COL 12 in FOF 3 in D.96-10-037, which applied only to small utilities.

Verizon alleges that TD singles Verizon out in its draft resolution to have Verizon refund amounts but it claims that by not requiring other impacted utilities from doing the same would be discriminatory.

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On August 3, 2004, Verizon filed reply comments responding to the July 28, 2004 comments of CBIA. Verizon alleges CBIA's reliance on revenue neutrality is misplaced. Verizon states that the tax gross-up is only an estimate and is not completely revenue neutral. Verizon argues that the rescission of COL 12 took into account that only Method 2 utilities should be required to issue refunds.

Responses to Comments

COL 12 in D.87-09-026 requires both Method 2 and Method 5 utilities to refund over-collected ITCC amounts to contributors. FOF 3 in D.96-10-037 rescinded COL 12, adopted a new COL 12 that only discusses Method 2 utilities, and, FOF 15 in D.02-10-040, which relies on D.96-10-037, are unclear.

FOF 3 in D.96-10-037 and FOF 15 in D.02-10-040 have not clearly indicated whether utilities using Method 5 for computing ITCC are subject to contributor claims for ITCC overpayments. Based on CBIA's protest only to Verizon AL 10584, TD has not singled out Verizon to refund any amounts to developers. TD is only addressing an issue raised by CBIA in its protest to Verizon's AL 10584.

Since SBC reads and interprets D.96-10-037 and D.02-10-040 differently than Verizon, despite the comments filed by parties to Verizon's AL 10584, TD still believes that the afore mentioned decisions are ambiguous. Therefore, TD recommends that the Commission direct Verizon to file an application to request clarification of FOF 3 in D.96-10-037 and FOF 15 in D.02-10-040 as to whether utilities should refund the ITCC amounts contributors over-paid the utilities under the Method 5 ITCC calculation from September 12, 2001 to September 11, 2003.

TD recognizes that retroactive application of the ITCC reduction would be an administrative burden. If after Commission clarifications on FOF 3 in D.96-10-037 and FOF 15 in D.02-10-040, Verizon is required to refund the ITCC amounts contributors over-paid, TD recommends Verizon negotiate with CBIA to reach an agreement over the ITCC amounts to be refunded, similar to what SBC and CBIA agreed to as previously described in this resolution by extending the currently reduced ITCC rate of 18.0% for additional months beyond the 2003 Act's sunset date of December 31, 2004.

Commission approval is based on the specifics of this Advice Letter and does not establish a precedent for the contents of future filings.

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Findings

1. Two sets of federal tax law changes applicable to the ITCC went into effect, one on September 11, 2001 and the other on May 5, 2003. Effective for property acquired after September 11, 2001 until May 5, 2003, the 2002 Act allowed a bonus depreciation of 30% in the first year. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (2003 Act), effective for property acquired after May 5, 2003 and before January 1, 2005, increased the bonus depreciation to 50% in the first year.
2. On August 1, 2003, SBC California (SBC), a utility using Method 5 as described in D.87-09-026 for computing the ITCC, filed AL 24059 to request authority to reduce the ITCC rate from 33.0% to 21.0% effective September 10, 2003.
3. CBIA protested SBC's requested effective date of September 10, 2003 in AL 24059.
4. CBIA raised the issue that the effective dates should be retroactive to September 11, 2001 and May 5, 2003 as the result of 2002 and 2003 Acts, respectively.
5. SBC and CBIA entered into a settlement agreement that resolved CBIA's protest. SBC subsequently filed AL 24253 on October 1, 2003, to request authority to extend the ITCC rate of 21.0% for an additional thirteen (13) month period beyond 2003 Act's sunset date of December 31, 2004 to January 31, 2006.
6. TD approved AL 24253 on November 10, 2003, and CBIA consequently withdrew its protest.
7. On August 12, 2003, Verizon filed AL 10584, to request a tariff revision that would lower its ITCC rate associated with CIAC from 31.9% to 18.0% due to the 2003 Act.
8. TD approved Verizon's AL 10584 for the ITCC rate change from 31.9% to 18.0%, and allowed Verizon's AL 10584 to go into effect on September 12, 2003 as requested by Verizon, but reserved the right to examine whether the ITCC should have been reduced effective September 11, 2001 and/or May 5, 2003, rather than September 12, 2003.
9. CBIA protested Verizon's requested effective date of September 12, 2003 in Verizon's AL 10584.
10. CBIA raised the issue that the effective dates should be retroactive to September 11, 2001 and May 5, 2003 as the result of 2002 and 2003 Acts, respectively.

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11. CBIA cites COL 12 in D.87-09-026 as the basis for claiming the retroactive applicability is required.
12. COL 12 in D.87-09-026 requires the utilities using Method 2 or Method 5 for computing ITCC to refund the different amounts between what was and what should have been collected to the contributors.
13. Verizon responded to CBIA's protest claiming that COL 12 in D.87-09-026 was rescinded in D.96-10-037 and replaced with new language that limits its applicability to those utilities which use Method 2 for computing ITCC (i.e. only small water and small telephone companies).
14. Verizon also cited FOF 15 in D.02-10-040, which states: "utilities using Method 5 are not subject to any claims for refund of CIAC gross-up amounts."
15. TD has reviewed Verizon's AL 10584, the protest of CBIA, and Verizon's response to the protest of CBIA.
16. The effective date(s) of the ITCC rate should be based on the federal tax code and the specific dates when the utilities began to realize the benefits of reduced tax liabilities and expenses. Utilities should revise their ITCC rates following each tax law change.
17. A retroactive application of the ITCC rate reduction would be an administrative burden.
18. With regard to the issue of whether developers are entitled to refunds of over-paid ITCC amounts from utilities using ITCC calculation Method 5, TD believes the existing Commission decisions are unclear. COL 12 in D.87-09-026 required both Method 2 and Method 5 utilities to refund over-collected ITCC amounts to contributors. D.96-10-037 rescinded COL 12, adopted a new COL 12 that only discusses Method 2 utilities, and failed to clearly address the status of refunds by Method 5 utilities. FOF 15 in D.02-10-040, which relies on D.96-10-036, is unclear for the same reason.
19. TD believes Verizon should have filed an advice letter to revise its ITCC rate each time the federal tax law changed it. TD believes Verizon's delays in amending its tariffs to reflect the change in ITCC rates are unreasonable.
20. TD is addressing an issue raised by CBIA in its protest to Verizon's AL 10584. TD has not singled out Verizon to refund any amounts to developers.

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21. Because of the ambiguity in D.96-10-037 and D.02-10-040, TD recommends that the Commission direct Verizon to file an application to request clarification of FOF 3 in D.96-10-037 and FOF 15 in D.02-10-040 as to whether utilities should refund the ITCC amounts contributors over-paid the utilities under the Method 5 ITCC calculation from September 12, 2001 to September 11, 2003.
22. We find TD's above recommendation reasonable.

THEREFORE, IT IS ORDERED that:

1. Within thirty days from the effective day of this resolution, Verizon shall file an application to request clarification of Finding of Fact (FOF) 3 in D.96-10-037 and FOF 15 in D.02-10-040 as to whether utilities should refund the ITCC amounts contributors over-paid utilities under the Method 5 ITCC calculation from September 12, 2001 to September 11, 2003.
2. Verizon shall maintain an accounting, on a monthly basis from September 13, 2003 identifying the following: (1) the ITCC tax revenue amounts Verizon collected; (2) the ITCC tax revenue using the IRS-mandated rate; and (3) the difference between (1) and (2), showing the revenue effects of the difference in ITCC tax rate(s) used by Verizon versus that mandated by IRS. This accounting Verizon shall continue until the Commission has indicated the refund issue for Verizon.

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This Resolution is effective today.

I hereby certify that this Resolution was adopted by the Public Utilities Commission at its regular meeting on August 19, 2004. The following Commissioners approved it.

STEVE LARSON
Executive Director